

CAMRI ROUNDTABLE DISCUSSION: MEETING SUMMARY

QE Tapering and Its Impact on Asia – Brian Fabbri

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(This is a meeting summary of the CAMRI Roundtable Discussion led by [Dr Brian Fabbri](#), CAMRI Visiting Research Fellow and President of FABBRI Global Economics.)

In the last 3 months, stock returns around the world have begun to disappoint. Since May 22 of this year, the focal point of discussion has been “Taper Terror”, which refers to the Quantitative Easing (QE) tapering statements made by Fed Chairman, Ben Bernanke. The peak in the Japanese Nikkei was achieved just around the same date as Chairman Bernanke announced that he was going to taper purchases of Treasury and mortgage-backed securities. Markets have traded down ever since, albeit U.S. stocks have traded evenly.

What is QE?

Quantitative Easing is a channel of monetary policy used by central banks to revive the national economy when the usual policies are exhausted. When interest rates are driven to zero, there is the fear of a liquidity trap, where interest on new loans would be zero. Then there is much less lending than desired. Consequently monetary policy is less effective. Because many central banks had lowered their policy rates close to zero, the next step had to be QE. The Japanese used it in the 90’s and again last year, and the British on several occasions. Basically, the Fed buys Treasury securities from dealer banks, which in turn provides reserves to dealer banks. The dealer banks can use these reserves to fund loans and back demand deposits to create economic activity. In the U.S. the reserve ratio is 10 to 1. In other words, for 1 dollar worth of reserves, 10 dollars of loans and demand deposits could be created.

To help the sluggish U.S. real estate market and struggling federal mortgage agencies, the Fed bought mortgage-backed securities in addition to Treasury securities. This was done with the hope that the former action would revive the mortgage market by allowing many homeowners to refinance their mortgages.

Was QE effective?

The Fed started with a balance sheet of around 870 billion dollars in 2008 and raised it up to 3.8 trillion dollars as of today. This is a three trillion dollar increase in their Treasury and mortgage-backed securities holdings. Given the 10 to 1 ratio on reserves to deposits, the Fed could have “liquefied” the entire world!

There are 3 principal paths through which QE works. First, the central bank can increase liquidity. Though there were periods when the increase in reserves did drive up money supply growth, they were followed by sharp declines in growth. Bank loans plunged in 2009 and have grown by only 5%, which is far less than they had been growing in the past, and far less than the potential if the banks had chosen to use all their reserves. Second, it lowers the cost of credit. When interest rates - both long and short - are reduced, the cost of credit goes down and presumably that should create more opportunities for investment. Third, there is a portfolio rebalancing effect. This has been the most powerful effect everywhere. In essence, as interest rates plunged, credit instruments lost their attractiveness, the money market fund business died, and investable funds poured into stocks and real estate. This is what the Fed wanted to see happen.

But was it effective? What did the banks do with the excess 3 trillion dollars worth of reserves? The banks used some of it, which is why loans growth was 5%, but they mostly just lent the money to one another, or to the Fed at 12.5 basis points per annum, a trivial return. There could be two reasons for this. First, banks are constrained by the leverage ratios they have to maintain, and hence have to lend very prudently. Second, it could be that banks did not see enough profitable opportunities to lend post-GFC. In 2008-09, though corporate profits were doubling, the demand for capital wasn't there either. And because the mortgage market was in disarray, it left banks with little else to do with their reserves.

When does QE work?

QE is essentially the same as open market operations. It will only work when the right incentives exist. A paper presented at the 2013 ABFER showed that when there are a lot of state-owned banks in the economy, QE works. But such cases are not good in the long run, like China's experience has shown.

Privately-owned banks respond to profit motives; hence jawboning may not be effective.

The 12.5 basis point deposit rate that the Fed gives to the banks is a subsidy using taxpayer funds, and is in essence a reverse tax. But this is also the reason for a portfolio rebalancing effect to take place. As a consequence, money supply measures such as M1 has grown while M2 hasn't because there was no incentive for investors to take on time deposits and savings. They had to go higher up on the risk curve to seek yields. Primarily, investors had taken money out of higher quality bond markets and put it into high yield bonds, stocks, REITS, commodities, etc. In the last 3-4 years during QE, the stock market increased significantly faster than GDP. Retail equity funds grew considerably, while money market mutual funds and bond funds declined. Presumably that would have built stock prices up and driven the economy, which is what the Fed wanted.

As mentioned, high yield bonds (which include emerging market bonds) did very well. The Fed, however, became concerned by this issue of investors "reaching for yield" in February of this year. But the markets chose to ignore this until May. This has also happened in emerging markets, which were the major beneficiaries of QE. The issue is that investor expectation that QE would never end could turn this into an asset inflation conundrum.

From the available research, it is unclear whether monetary policy is effective in impacting the real economy in today's globalized world, and whether it can really change investment behavior. In some cases, it can lead to distortionary investments, like in China where prices in real estate went up. This did however drive a lot of real estate activity in China, which created income for many migrant workers. Thus there will always be a balance between the distortionary effects and real impact. It is not clear whether these impacts are short-term or long-term.

Did the Fed achieve its objectives?

The Fed's objectives are primarily domestic (growth, jobs, etc.) but its way of achieving them is global. In essence, given the U.S.'s view that the emerging world was slow to adjust domestic currencies upwards, QE drove up inflation in their markets thus forcing them to rebalance. This has historically been the

case. After all, it has been recorded that a Treasury official famously told a group of European finance ministers (worried about the export of American inflation to Europe) that “the dollar is our currency, but your problem”.

Since the whole world saves in the U.S. currency, the U.S. should be able to carry on with Keynesian fiscal spending for a long time, just like Japan. But there is a huge impetus on banks to draw on excess reserves so as to fuel credit growth. The Fed can intervene in terms of the broad money expansion by increasing the interest rates on reserves. In other words it does have an exit strategy.

What happens when QE ends?

We already are experiencing the shocks to the market as the Fed wavers as to when to commence QE tapering. The taper may begin in 3 months, but by that time the markets would have priced 90% of that in. Whether it is bond yields that go up over a 100 basis points, foreign exchange rates in emerging markets that plunge, or reserve assets in some of the emerging markets that are depleted to shore up the falling currency, much has already happened.

The end of QE is when the central bank stops buying additional securities. When it starts selling securities that is the beginning of tightening. But there is an intermediate step. At the end of QE, long term interest rates would have gone up, the search for yield would have slowed down, credit spreads would have widened, bond exchange rates would have fallen relative to the Dollar and the Euro, etc. That’s the way the market will look when QE is over, which is estimated to be one and the half years from now. Then the Fed will still have a funds rate of 12.5 basis points, which is not neutral, and so it will have to raise the funds rate up towards neutrality. The Fed funds rates is expected to rise up to the U.S.’s GDP growth rate in a neutral, full-employment scenario. Since that growth rate is about 2.5%, it needs to be built into investor portfolios.

We haven’t mentioned tightening so far because there is no inflation. Once inflation threatens the Fed’s tolerance limit, it will have to raise the policy rate. Full employment leads to labor cost increases and so on, at that point it will have to start thinking about tightening. The Fed Fund rate will go from its neutral level to something significantly higher to calm things down again. But this will not happen in the near term given the U.S. does not seem to be showing any sign of exceeding its supply potential.

On the other hand, many emerging countries are already tightening monetary policy. This is because asset inflation is surfacing in emerging markets. Some of these excesses are disappearing, particularly in stock markets and in real estate markets, including in Singapore's.

The Great Depression was prolonged in 1937 because of the doubling-up of reserve requirements. After ineffective money supply measures, the central bank was worried about inflation and mistakenly retracted, thus prolonging the Great Depression. There are many reasons why this may not happen now. Firstly, the Fed has learnt from its previous experiences and is more prepared now. Second, the Fed now resorts to **forward policy guidance** to influence the markets, example, Chairman Bernanke's comment a few years ago on keeping interest rates low for a long time, which had implications for money markets. But the real concern is that articulating policies via forward guidance, whether it is on QE, interest rates, or a combination of many things, could lead to unintended consequences.

Forward guidance as a channel of transmission of monetary policy

Forward guidance is critical because we don't know fully if QE works and in what ways. The economist Michael Woodford argued that it is now being seen as an important way in which monetary policy achieves its objectives, and perhaps the most important channel of transmission. In some ways, listening to what the Fed says has become more important than observing what it does.

So far, the Fed has not really done anything. They are still buying 85 billion dollars worth of securities a month; they have only signaled on May 22nd that they will exit from QE. So the Fed is trying to differentiate tapering from a hike, albeit the market is not differentiating between the two. The modal point of the first expected date of the hike has been brought forward a full year - the short term rate expectation has changed since May 22nd - the market is not reacting to what the Fed is saying, and so there may be unintended consequences.

Forward guidance is a market moving event relative to having to wait till the Fed starts acting. The argument goes that markets would have reached its equilibrium value by the time the Fed ends QE and by the time they start to make tightening decisions. So if the Fed's forward communication skills are indeed good, they would move markets gradually and smoothly, thus

preventing distortions that get created when the move comes as a sudden surprise. But forward guidance in itself is just as fuzzy as incoming data - the way different people judge such statements could be different. It could also be intended to misrepresent so as to not allow markets to short circuit the recovery. Though the opinions of the Fed Chairman are presumably based on the data, interpretations can differ, potentially making forward guidance a dangerous tool.

With forward guidance, the Fed may challenge the markets in different ways than they have in the past, but it will still be discretionary. The decisions taken today are more on the go than by the rule book. A Fed governor, Jeremy Stein, recently argued that there is a lack of evidence of the impact of quantitative easing on growth or jobs, albeit it did result in asset bubbles.

Impact on emerging markets

The Fed usually doesn't raise interest rates until the U.S. economy is doing well. And because the U.S. economy is doing well, the emerging markets should do well, too. But history shows otherwise. When the Fed raises rates, there is usually an emerging markets crisis. Can this be expected in the current situation?

The impact on emerging markets is likely to be very severe. When the Fed starts to taper, emerging markets will get hit with capital outflows, economic growth will slow and they won't get the benefits from higher growth in the U.S. They will get higher rates, lower growth and drastic hits on the balance sheet because there is plenty of foreign funding in emerging markets. Since interest rates were close to zero after the subprime crisis, and the U.S. dollar was weakening, these countries had increased their borrowing significantly. There may be a case for capital controls but most countries are not showing any interest in implementing such measures.

Until recently the markets thought that emerging markets will do well since the U.S. economy is improving, which may be a dangerous assumption. Countries in the region should be preparing for another 1997, though they seem to be preparing for a 2008. The reason for this is that emerging markets have much stronger balance sheets today than they had in 1997, which may provide a false sense of security. Just prior to 1997, the bulk of the Asian economies were running current account deficits. In many cases, they moved

from a surplus to a deficit within 3 quarters. The balance of payments crisis in some countries today is much bigger. So there will be a fall-out effect, i.e., there will be significant demand shocks in some of these key economies, and even those with healthier balance sheets will have a demand shock because of what the emerging market economies are going through. In addition, this time around a lot of the asset-liability mismatches are in the private sector rather than the sovereign sector, like in 1991 in India and during the Korean crisis from 1997-98.

Black money and shadow banking are other growing concerns. A report indicated 2.7 trillion dollars of black money flowed out of China in the last 5 years, and there is a 6 trillion dollar wealth management product problem, broadly known as shadow banking. Data on the size of these markets is not even available in most Asian countries though it affects leverage ratios to a great extent.

On a positive note, energy markets in the U.S. look very different from what they were the last time. It is not clear whether it is QE or the structural changes in the U.S. energy sector that is fuelling the growth in the American economy right now. Energy sufficiency in the U.S. has created a shift in policy, and will be a part of why the American GDP is going to grow. That being said, the biggest export market for South East Asian countries is Europe. As a consequence, SEA is not going to be helped much by this U.S. economic growth. If the Fed normalizes interest rates in the next year or two, and then starts tightening in 3 - 4 years, the rest of the world will experience more shocks.

The Fed will continue to give guidance to allow the markets to move in the current direction and see whether higher rates and a stronger dollar affect U.S. economic growth. If it doesn't, the guidance will continue. If it does, the Fed will stop guidance and resume buying securities. This guidance experience has shown the Fed that it has the chance to observe the effects of its policies without actually fully implementing them.

Conclusion

Asian emerging markets have to recognize that they have excess liquidity and other issues, and not just look at the recent outflows as a portfolio rebalancing problem created by international funds. There is massively more leverage in the system today than what everyone anticipated. After the Asian crisis, central banks have relied on gathering better data - but this is not being done effectively. Whether it is on shadow banking or any other macro trend, we should rely on data to identify new hotspots that we never anticipated.

Since ASEAN is only a 2.2 trillion dollar economy, it will take much less monetary subsidies to revive these countries post-crisis. For instance, during the 2008 crisis, Singapore pumped 20 billion dollars into its economy from its excess reserves alone, and not by QE. In other words, Singapore can take care of itself. The other ASEAN nations are small, and so in the long run the view is bullish on Asia, but against Europe and the U.S., where the forecasted growth is less than 1%, and 2 - 2.5%, respectively.

The financial crisis doesn't necessarily have to be a deep economic crisis. But that will depend on how policymakers react to the present capital outflows. Since the money is going out and currencies are going down, they will probably increase interest rates to keep currency in and will have to use reserves to prevent the currency from dropping too much. In China for example, they can carve money out of reserves and start putting money into places that are over-leveraged and under-productive. Primarily, it is a question of moving money inwards rather than investing outside.

It is important to consider though that in 1997, there were pockets of relative stability, example India, China and Singapore. But now everyone is leveraged up, either in their own currency or in combination with external currencies. In China, the credit to GDP ratio has gone from 120 - 130% of GDP to 200% of GDP. It is evident that there is a very heavy dependence on the recovery of the U.S. for the rest of the world. Hopefully, policymakers in Asian countries will not take the same approach as policy makers did in Europe because austerity would deepen the Asian crisis.